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## WISCONSIN LEGISLATIVE COUNCIL AMENDMENT MEMO

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<b>2005 Senate Bill 93</b>	<b>Senate Substitute Amendment 1</b>
<i>Memo published: April 13, 2005</i>	<i>Contact: Nicholas Zavos, Staff Attorney (266-1308) Dan Schmidt, Senior Analyst (267-7251)</i>

### **CURRENT LAW**

Current Law provides guidelines for trustee allocation and distribution of trust income and principal when the trust documents do not specify any specific treatment. Current law was adopted from the Revised Uniform Principal and Income Act of 1962.

### **2005 SENATE BILL 93**

2005 Senate Bill 93 is intended to replace the Revised Uniform Principal and Income Act of 1962 to reflect current trust law. The bill is based on the Uniform Principal and Income Act of 1997, but makes certain modifications that do not replicate the exact content of the uniform law.

### **Allocation of Receipts**

Determining which portion of a trust is principal versus which portion is income can be a difficult task. Complications can occur when a trustee must establish how receipts to a trust are allocated between these two categories. The bill seeks to simplify this task by establishing rules for allocating trust receipts during the pendency of a trust, after an income interest in a trust ends, and upon distribution of decedent's estate. A variety of specific receipts are treated in the bill, including:

- Distributions from another trust or an estate.
- Business and other activities conducted by a trustee.
- Rental property.
- Interest received as a result of obligations to pay money to the trust or trustee.

- Proceeds from insurance policies or other contracts where the trust or trustee is named beneficiary.
- Deferred compensation, annuities, and similar payments.
- Liquidated assets.
- Interests in minerals, water, and other natural resources.
- Sales of timber and related products.
- Proceeds that provide collateral for securities (asset-backed securities).
- Transactions in derivatives and options.

In addition to apportionment of receipts and distributions, the bill provides rules for establishing when a beneficiary's right to income begins and ends under the terms of a trust.

### **Allocation of Distributions**

Like receipts, distributions or disbursements from a trust are also allocated from income or principal. The bill generally provides that in addition to amounts paid to income beneficiaries, trust income must be used to pay the following:

- One-half of the regular compensation of the trustee and any person providing investment, advisory, or custodian services to the trustee.
- One-half of all expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests.
- All other ordinary expenses incurred in connection with the administration, management, or preservation of trust property and the distribution of income.
- Recurring premiums on insurance covering the loss of a principal asset or the loss of income from use of the asset.

The remaining one-half of the aforementioned income distributions and most other costs not associated with the direct administration of the trust, including payments on debt, transfer taxes, and penalties, are made from principal.

### **Transfer Adjustment Powers**

The bill provides rules for a trustee to make certain transfers and adjustments between principal and income to the extent the trustee manages the assets as a prudent investor and represents the terms of the will or trust. The bill provides guidelines for judicial review of a trustee's adjustment actions relative to a trust.

The bill also permits the conversion of a trust to a *unitrust* under certain specified circumstances. A unitrust is a vehicle in which the allocation of income and principal is simplified by providing that a fixed percentage of the trust, generally limited to 3% to 5% of the trust's total assets as averaged over a three-year time period, will be considered income.

### **Limits on Liability**

The bill provides that if a trustee sends to all beneficiaries a written communication relating to a trust, any action against the trustee that is based on the subject of the written communication must be commenced within two years after the trustee sends the written communication or be barred. However, this provision does not apply to an action based on fraud or misrepresentation with respect to the written communication.

### **SENATE SUBSTITUTE AMENDMENT 1 TO 2005 SENATE BILL 93**

The provisions of the substitute amendment are substantially similar to those of the bill with the following exceptions:

#### **Property Held in Trust in Perpetuity**

Senate Substitute Amendment 1 provides that trust principal may also be defined as property held in trust in perpetuity. Senate Bill 93 originally defined principal as property held in trust for distribution to a remainder beneficiary when the trust terminates.

#### **Limitations on Trustees' Powers to Adjust**

The substitute amendment makes a number of language changes to the bill's original limitations on trustees' powers to adjust the principal and income portions of a trust. The proponents of the substitute amendment (the Wisconsin Bankers Association and the State Bar of Wisconsin) indicate that these changes were intended to simplify the language of the Uniform Act and ensure compliance with federal regulations.

#### ***Adjustments That Disqualify Certain Tax Deductions***

The substitute amendment clarifies that a trustee may not make an adjustment to trust principal or income if possessing or exercising the power to make an adjustment would disqualify an estate, gift tax marital, or charitable deduction in whole or in part.

#### ***Adjustments to Charitable Trust Amounts***

The substitute amendment also puts further limitations on adjustments to trust amounts that are set aside for charitable purposes. Under the bill, a trustee may not make an adjustment to an amount that is set aside for charitable purposes unless both income and principal are set aside. The substitute amendment narrows this provision by limiting adjustments to the amount set aside for charitable purposes to which an estate tax or gift tax charitable deduction has been performed.

### ***Adjustments That Trigger Estate Taxes***

The substitute amendment deletes the portion of the provision that prohibits adjustments that trigger certain estate taxes. The bill limits the application of this provision to an individual who has the power to remove a trustee or appoint a trustee. Under the substitute amendment, the provision applies to the estate of any individual, regardless of their powers to remove or appoint the trustee.

### ***Adjustments Which Benefit the Trustee***

The substitute amendment deletes the prohibition on trustees making adjustments that would benefit the trustee if the trustee is not the beneficiary of the trust. The bill prohibited adjustments that benefit a trustee directly or indirectly. The proponents of the amendment indicated that this prohibition was not clear regarding what constitutes a direct or indirect benefit and that the Internal Revenue Service regulations do not have such a prohibition.

### ***Adjustments to Unitrusts***

The substitute amendment prohibits trustees from making an adjustment to a unitrust, either express or converted. The bill has no such prohibition. The proponents of the substitute amendment indicated that adjustments to unitrusts are unnecessary because the substitute amendment provides for treatment of unitrusts.

### **Notification of Beneficiaries**

The substitute amendment expands the notification provisions of the bill to include intermediary beneficiaries who may have an interest in a trust but are not currently receiving income or remainder benefits. The bill's notice provisions only apply to current income beneficiaries and certain specified remainder beneficiaries. In addition, the substitute amendment requires that the beneficiary who has been notified and objects to a trustee's action has the burden of proving that the change should be modified or prohibited. The bill applied the burden of proof to the notified beneficiary in instances where the beneficiary sought a prohibition of the action, not modification.

### **Prudent Investor Requirements for Unitrusts**

The substitute amendment deletes the section of the bill that states that a trustee who converts a trust to a unitrust must invest and manage trust assets in accordance with the Uniform Prudent Investor Act. This does not alter the requirement that a trustee act as a prudent investor. A trustee of a unitrust must continue to follow the requirements of the Uniform Prudent Investor Act. [s. 881.01, Stats.]

### **Unitrust Distributions**

The substitute amendment defines unitrust income as a fixed percentage of the net fair market value of the unitrust's assets, regardless of whether considered income or principal, averaged over a three- to five-year period or averaged over the period since the original trust was created if in existence for less than five years. The bill originally defined unitrust income as principal and income averaged over a three-year period. The three- to five-year period provides the trustee with greater flexibility in determining unitrust income over time. The substitute amendment also permits the trustee to alter the

averaging period of the unitrust to a different preceding period with proper notice and beneficiary approval.

### **Unitrust Distribution Priority**

The substitute amendment alters distribution priority to include ordinary income as the second source of distributed funds. The distribution is generally attributed to a unitrust in the following order:

1. Net income.
2. Ordinary income.
3. Short-term capital gains.
4. Long-term capital gains.
5. Principal.

The bill did not include ordinary income in the distribution schedule. The proponents of the substitute amendment indicate that the inclusion of ordinary income complies with federal Internal Revenue Service regulations.

### **Unitrust Tax Applications**

The substitute amendment removes the term “federal” when referring to the tax treatment of unitrusts. The beneficiary of a unitrust is treated as an owner for income tax purposes and unitrust assets may be subject to estate or gift taxes. The bill limited these tax treatments to federal income, estate, and gift taxes.

### **Trustee Release of Power to Convert to a Unitrust**

The substitute amendment permits a trustee to release the power to convert a trust to a unitrust under certain specified circumstances if the trustee determines that the conversion may affect tax benefits, tax burdens, or other unitrust conversion prohibitions. The bill did not contain a provision for the release of power of unitrust conversion.

### **Express Unitrusts**

The substitute amendment establishes distribution treatments that are substantially similar to those found in conversion unitrusts, but that apply to express unitrusts. Express unitrusts are unitrusts that are drafted into trust documents rather than converted to unitrusts by a trustee. The bill does not establish any provisions regulating express unitrusts. It refers to conversion unitrusts only.

### **Liability Limits**

The substitute amendment includes provisions limiting the liability of trustees for their use of certain discretionary powers. The substitute amendment states that a trustee does not have a duty and

that it is not an abuse of power for a trustee to decide not to make adjustments or to not convert a trust to a unitrust. The bill originally provided liability protection for a trustee's decision to make an adjustment or conversion, not for decisions to **not** make an adjustment or conversion.

**Effective Date**

The substitute amendment applies the effective date to all of s. 701.20 and deletes the redundant effective date established for s. 701.24 (4g) (a) 1.

On April 7, 2005, the Senate Committee on Housing and Financial Institutions introduced and recommended adoption of Senate Substitute Amendment 1, and recommended passage of Senate Bill 93 as amended, by a vote of Ayes, 7; Noes, 0.

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